Internal Revenue Service

memorandum

CC:TL-N-3376-88
Br4:CBBehling

date: MAR 31 1988

to: District Counsel, Atlanta SE:ATL
Attn: Albert L. Sandlin, Jr.

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

This memorandum responds to your request for technical advice in the above-referenced Tax Court case.

ISSUES

1. Whether it is appropriate for the disqualified person/foundation manager and the private foundation to contest the assertion of private foundation excise taxes in one Tax Court petition.

2. Whether the burden of proof is on the Commissioner with respect to the private foundation excise taxes asserted under I.R.C. sections 4941 and 4945.

3. Whether the Commissioner has asserted all appropriate private foundation excise taxes and penalties.

4. Whether the statute of limitations has run with respect to the assertion of any additional private foundation excise taxes and penalties.

5. Whether the private foundation excise taxes have been computed properly.

FACTS

[redacted], a private foundation within the meaning of I.R.C. section 509(a), was formed by a deed of trust in [redacted] for the purpose of contributing funds to

other charitable organizations. Since [redacted] has made charitable contributions to only one organization, the [redacted]. These contributions totalled $[redacted] during [redacted] and [redacted].

[redacted], became a trustee of [redacted] in [redacted]. Since [redacted] he has served as [redacted]'s sole trustee. [redacted] had no written provisions relating to the payment of fees and other compensation for trustee services. [redacted], as trustee, paid [redacted] funds to himself for his personal use in the amounts of $[redacted] and $[redacted] respectively during [redacted] and [redacted]. During this period, [redacted] principal duties consisted of managing [redacted]'s assets, which were valued between $[redacted] to $[redacted]. The payments to [redacted] were reported on Forms 990-PF as "compensation of officers, etc." The payments were made at irregular intervals and in irregular amounts bearing no identifiable relationship to any services [redacted] performed for [redacted]. In [redacted] purchased a computer and paid [redacted] expenses for a college level computer course. [redacted] also provided [redacted] with automobiles for his exclusive use.

Trustees of private foundations have stated that annual fees for management of trusts of the nature and size of [redacted] would have ranged from $1,000 to $2,000 annually.

The Service mailed statutory notices of deficiency dated [redacted], to [redacted] and to [redacted] asserting liability for taxes under Chapter 42. [redacted] and [redacted] timely filed a joint petition in the Tax Court on [redacted].

DISCUSSION

1. Permissive Joinder of Parties

Tax Court Rule 61(a) provides that, under specified conditions, two or more parties receiving separate statutory notices of deficiency may file a single Tax Court petition that is timely with respect to the notice issued to each joining party. Joinder is permitted "only where all or part of each participating party's tax liability arises out of the same transaction, occurrence, or series of transactions and occurrences and, in addition, there is a common question of law or fact relating to those parties." T.C. Rule 61(a); see also Internal Revenue Manual section (35)4(13)1.

The approach of Rule 61(a) is to allow joinder within the terms of the rule, but Rule 61(b) gives the Tax Court ultimate and broad discretion to sever the parties or their claims to the extent it considers appropriate. Rule 61(b) provides that

> the Court may make such orders as will prevent a party from being embarrassed, delayed, or put to expense by the inclusion of a party; or may order separate trials or make other orders to prevent delay or prejudice; or may limit the trial to the claims of one or more parties, either dropping other parties from the case on such terms as are just or holding in abeyance the proceedings with respect to them. Any claim by or against a party may be severed and proceeded with separately.

Any determination that the excise tax under I.R.C. section 4941 is to be imposed requires the existence of three elements: (1) a private foundation, (2) a disqualified person, and (3) an act of self-dealing between the two. See generally Treas. Reg. section 53.4941(d)-2. The payment of excessive compensation by a private foundation to a disqualified person constitutes an act of self-dealing. See generally Treas. Reg. section 53.4941(d)-3(c)(1). Moreover, expenditures for unreasonable administrative expenses, including compensation and other fees for services rendered, are ordinarily taxable expenditures under I.R.C. section 4945(d)(5) "unless the foundation can demonstrate that such expenses were paid or incurred in the good faith belief that they were reasonable and that the payment or incurrence of such expenses in such amounts was consistent with ordinary business care and prudence." Treas. Reg. section 53.4945-6(b)(2). The determination of whether an expenditure is unreasonable depends upon the facts and circumstances of the particular case. Id.

Thus, whether the payment of compensation by the [redacted] to [redacted] constitutes an act of self-dealing within the meaning of I.R.C. section 4941(d)(1)(D) and whether the payment is to be treated as a taxable expenditure within the meaning of I.R.C. section 4945(d)(5) are questions of fact resulting from the same transaction or occurrence. Because each participating party's tax liability arises out of the same transaction, occurrence, or series of transactions and occurrences and because a common question of fact relates to those parties, we conclude that, under the terms of Tax Court Rule 61(a), the parties may file a single Tax Court petition. 1/

1/ You should note that if [redacted] represents himself and the [redacted] before the Tax Court, then a conflict of interest may arise.

2. Burden of Proof

Tax Court Rule 142(a) provides that

> the burden of proof shall be upon the petitioner, except as otherwise provided by statute or determined by the Court; and except that, in respect to any new matter, increases in deficiency, and affirmative defenses, pleaded in his answer, it shall be upon the respondent.

I.R.C. section 7454(b) and Tax Court Rule 142(c) specifically provide that the burden of proof is on the Commissioner in any proceeding involving the issue whether a foundation manager, as defined in I.R.C. section 4946(b), has "knowingly" participated in an act of self-dealing within the meaning of I.R.C. section 4941 or agreed to the making of a taxable expenditure within the meaning of I.R.C. section 4945. The Commissioner carries that burden of proof by clear and convincing evidence. T.C. Rule 142(c).

Tax Court Rule 36(b) provides that the answer must contain "a clear and concise statement of every ground, together with the facts in support thereof, on which the Commissioner relies and has the burden of proof." Therefore, the Commissioner would have the burden of pleading with respect to the issue of the knowing conduct of a foundation manager.

However, Tax Court Rule 34(b)(4) provides that the petition must contain

> clear and concise assignments of each and every error which the petitioner alleges to have been committed by the Commissioner in the determination of the deficiency or liability. The assignments of error shall include issues in respect of which the burden of proof is on the Commissioner. Any issue not raised in the assignment of errors shall be deemed to be conceded. Each assignment of error shall be separately lettered.

Therefore, if the petition does not assign error with respect to the knowing conduct of a foundation manager, then the taxpayer is deemed to have conceded such issue and the Commissioner does not have any burden of pleading or proof with respect to it. See Note, 60 T.C. 1085 (1973).

I.R.C. section 4946(b) defines "foundation manager" to mean an officer, director, or trustee of a private foundation. Therefore, because [redacted] was the trustee of the [redacted] during the taxable years [redacted] and [redacted] he was both a foundation manager and a disqualified person with

respect to the private foundation. See I.R.C. section 4946(a)(1)(B). [redacted] participated in the transaction giving rise to the act of self-dealing both as a disqualified person and in his capacity as a foundation manager. Accordingly, he is liable for the I.R.C. section 4941(a)(1) tax on a self-dealer and, because he participated in the transaction in part as a trustee, for the I.R.C. section 4941(a)(2) tax on a foundation manager. See Rev. Rul. 78-76, 1978-1 C.B. 377.

We note, however, that the Service did not assert in its statutory notice of deficiency that [redacted] is liable for the I.R.C. 4941(a)(2) tax imposed on him as a foundation manager who participated in an act of self-dealing. Moreover, the Service did not assert in its statutory notice of deficiency that [redacted] is liable for the I.R.C. section 4945(a)(2) tax imposed on him as a foundation manager who knowingly agreed to the making of a taxable expenditure by a private foundation. Therefore, the case does not involve the knowing conduct of a foundation manager as set forth in the provisions of I.R.C. sections 4941, 4944, or 4945. As such, the Commissioner does not have the burden of proof under I.R.C. section 7454(b) and Tax Court Rule 142(c). Instead, Tax Court Rule 142(a) applies, placing the burden of proof upon [redacted].

Similarly, the burden of proof with respect to the excise tax imposed under section 4945(a)(1) lies with the [redacted]. Larchmont Foundation, Inc. v. Commissioner, 72 T.C. 131, 137 (1979). The burden of proof is on the private foundation because I.R.C. section 4945(a)(1) does not require knowing, willful, or fraudulent conduct by the private foundation.

In light of the above analysis, we do not need to reach the question of whether the petition contains clear and concise assignments of error, including issues in respect of which the burden of proof is on the Commissioner. Likewise, we need not reach the question of whether the answer contains a clear and concise statement of every ground, together with the facts and support thereof, on which the Commissioner relies and has the burden of proof.

3. Imposition of Other Private Foundation Excise Taxes

In any case in which I.R.C. section 4941(a)(1) applies, section 4941(a)(2) imposes a tax of 2 1/2 percent of the amount involved on the participation of any foundation manager in the act of self-dealing, but only if the foundation manager knowingly participated in the act. This tax is not imposed where the participation is not willful and is due to reasonable cause. The foundation manager must pay the tax.

As we noted above, [redacted] is the disqualified person who participated in the transaction giving rise to the act of self-dealing both as a self-dealer and in his capacity as a foundation manager. Therefore, as a foundation manager of the trust, [redacted] is liable for the 2 1/2 percent tax under I.R.C. section 4941(a)(2). Thus, the statutory notice of deficiency should have asserted that [redacted] is also liable for the excise tax under I.R.C. section 4941(a)(2).

Similarly, I.R.C. section 4945(a)(2) imposes an excise tax on the agreement of any foundation manager to the making of a taxable expenditure by a foundation. The foundation manager must pay the tax, which is at the rate of 2 1/2 percent of each taxable expenditure. Because the Service is asserting that the [redacted] is liable for the excise tax under I.R.C. section 4945(a)(1), the statutory notice of deficiency should have asserted that [redacted] is also liable for the excise tax under I.R.C. section 4945(a)(2).

Finally, we note that I.R.C. section 6684 provides in part as follows:

> If any person becomes liable for tax under any section of chapter 42 (relating to private foundations) by reason of any act or failure to act which is not due to reasonable cause and . . . such act or failure to act is both willful and flagrant, then such person shall be liable for a penalty equal to the amount of such tax.

For purposes of I.R.C. section 6684, the term "person" includes a trust. See Treas. Reg. section 301.6684-1(a); I.R.C. section 7701(a)(1). The terms "willful and flagrant" have the same meaning for purposes of I.R.C. section 6684 as they do under I.R.C. section 507(a)(2)(A) and the regulations promulgated thereunder. Treas. Reg. section 301.6684-1(c). Section 1.507-1(c)(2) of the regulations defines an act that is "willful and flagrant" as one "which is voluntarily, consciously, and knowingly committed in violation of any provision of Chapter 42 (other than Section 4940 or 4948(a)) and which appears to a reasonable man to be a gross violation of any such provision."

The Service did not assert that the section 6684 penalty applies to [redacted]. The amount of the penalty would be equal to the excise taxes for which [redacted] is liable under I.R.C. sections 4941(a)(1) and (2) and 4945(a)(2). Similarly, the Service did not assert that the penalty applies to the [redacted], a trust that is liable for tax under I.R.C. section 4945. See Treas. Reg. section 301.6684-1(a)(1). If the Service asserts the section 6684 penalty against [redacted] and the [redacted], then the Commissioner

has the burden of proof of presenting clear and convincing evidence on the issue of "willful and flagrant." Larchmont Foundation, Inc. v. Commissioner, 72 T.C. 131, 139 (1979).

4. Statute of Limitations

As noted above, the statutory notice of deficiency did not include [redacted] liability as a foundation manager for the excise taxes under I.R.C. sections 4941(a)(2) and 4945(a)(2). Moreover, the statutory notice did not impose the I.R.C. section 6684 penalty on [redacted] and on the [redacted] as persons liable for tax under Chapter 42.

You have asked us to discuss the application of the statute of limitations to the Service's assertion of other appropriate private foundation excise taxes. I.R.C. section 6501(a) provides that, except as otherwise provided in that section, the amount of any tax imposed by Title 26 of the United States Code (which includes I.R.C. sections 4941 and 4945) shall be assessed within three years after the return was filed (whether or not the return was filed on or after the date prescribed), and no proceeding in court without assesment for the collection of the tax shall be begun after the expiration of that period.

Under I.R.C. section 6501(e)(3), the statute of limitations is six years whenever the applicable return omits an amount of a tax imposed under any provision of subtitle D (which includes Chapter 42 excise taxes) which exceeds 25% of the amount of tax reported thereon. I.R.C. section 6501(e)(3) further provides that, in determining the amount of tax omitted from the return,

> there shall not be taken into account any amount of tax imposed by chapter . . . 42 . . . which is omitted from the return if the transaction giving rise to such tax is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary of the existence and nature of such item.

I.R.C. section 6501(l)(1) provides that, for purposes of the Chapter 42 excise taxes, the return referred to is the return of the private foundation for the year in which the prohibited transaction occurred. Thus, although the excise tax is imposed annually, only one period of limitations is applicable to each prohibited act. This period is measured by reference to the filing or due date of the return the private foundation filed for the year in which the prohibited transaction occurred. See Statute of Limitations for Purposes of Sections 4971 and 4975; Statute of Limitations for Purposes of Section 4941, G.C.M. 39066, EE-128-81 (February 24, 1983) (copy enclosed).

Your request for technical advice does not reveal when the [redacted] filed its returns for the taxable years covered by the statutory notice of deficiency. Moreover, your request does not indicate whether I.R.C. section 6501(e)(3) is applicable. However, in light of G.C.M. 39066, we advise you that only one period of limitations is applicable to all the tax attributable to an act of self-dealing (or prohibited transaction). That period begins by reference to the return the private foundation filed for the year in which the act giving rise to the liability for the tax occurred and ends three or six years later, depending on whether the private foundation adequately disclosed the act on that return. Whether a return "adequately discloses" a transaction giving rise to a Chapter 42 excise tax is inherently a factual question on which the Commissioner has the burden of proof. See, e.g., Peters v. Commissioner, 51 T.C. 226, 230 (1968).

Furthermore, I.R.C. section 6212(c)(1) provides that if the Service has mailed a valid notice of deficiency to a taxpayer who subsequently has filed a timely petition with the Tax Court, then the Service is restricted from sending the taxpayer an additional notice with respect to other Chapter 42 excise taxes arising from any act (or failure to act) to which the petition relates. This restriction does not apply in the cases of fraud, termination, or jeopardy assessments. We note, of course, that I.R.C. section 6214(a) authorizes the Tax Court to redetermine the correct amount of a deficiency. The redetermination may result in an increased deficiency if the Service timely asserts its claim for an additional deficiency at or before the hearing or rehearing. If the Service raises new matters before the Tax Court, then the burden of proof is on the Commisioner. T.C. Rule 141(a).

With respect to I.R.C. section 6684, the penalty must be paid upon notice and demand and is assessed and collected in the same manner as taxes. I.R.C. section 6671(a). The term "tax" in the Internal Revenue Code of 1986 includes the I.R.C. section 6684 penalty, except as otherwise provided. Id. Thus, the provisions of I.R.C. sections 6501(a) and (e), as discussed above, provide the applicable statutes of limitations for purposes of the I.R.C. section 6684 penalty. Moreover, as the Service concluded in G.C.M. 39066 at page 1,

> there is only one period of limitation applicable to all the tax attributable to an act of self-dealing (or prohibited transaction). This period begins by reference to the return filed by the . . . private foundation for the year in which the act giving rise to the liability for the tax occurred and ends three or six years later, depending on whether the act was adequately disclosed on that return.

5. Computation of the Private Foundation Excise Taxes

You have asked us to determine if the Service properly computed the private foundation excise taxes. Because we do not have the administrative file, you should submit the case for a computation to an experienced Tax Law Specialist in your key district.

We do note, however, that I.R.C. section 4941(a)(1) imposes on the self-dealer a first-tier tax on an act of self-dealing. The first-tier tax is imposed each taxable year, or partial year, during the taxable period. I.R.C. section 4941(a)(1). The taxable year refers to the disqualified person's, not the private foundation's, taxable year. Rev. Rul. 75-391, 1975-2 C.B. 446. The taxable period begins on the date an act of self-dealing occurs and ends on the earliest of the following dates: (1) the mailing of a notice of deficiency with respect to the first-tier tax; (2) assessment of the deficiency; or (3) correction of the act of self-dealing. I.R.C. section 4941(e)(1).

The date of occurrence is the date on which all the conditions and terms of the transaction and all the liabilities of the parties are fixed. Treas. Reg. section 53.4941(e)-1(a)(2). This definition is similar to the definition of the accrual method of accounting. See Treas. Reg. section 1.446-1(c)(1)(ii). Thus, if on June 15, 1988, a private foundation gave a disqualified person a binding option to purchase real estate on July 15, 1988, the act of self-dealing occurred on June 15, 1988. If the Service mails a notice of deficiency with respect to the first-tier tax on March 15, 1990, the taxable period ends on that date, assuming that the disqualified person has not corrected the self-dealing act on an earlier date. As such, a 5% tax will be imposed for 1988, 1989, and 1990 on the disqualified person (a calendar-year taxpayer) on the value of the option. See Treas. Reg. section 53.4941(e)-1(a)(4) Example (1).

The base on which the self-dealing taxes are levied is the amount involved. Generally, the term "amount involved" means the greater of the amount of money plus the fair market value of other property given or the amount of money plus the fair market value of other property received by the disqualified person. I.R.C. section 4941(e)(2); Treas. Reg. section 53.4941(e)-1(b)(1),(2). The date for determining the fair market value of any property exchanged is the date of occurrence. I.R.C. section 4941(e)(2)(A); Treas. Reg. section 53.4941(e)-1(b)(3).

An exception to the above principle applies to transactions of an ongoing nature:

> If, however, such transaction relates to the leasing of property, the lending of money or other extension of credit, other use of money or property, or payment of compensation, the transaction will generally be treated (for purposes of section 4941 but not section 507 or 6684) as giving rise to an act of self-dealing on the day the transaction occurs plus an act of self-dealing on the first day of each taxable year or portion of a taxable year which is within the taxable period and which begins after the taxable year in which the transaction occurs.

Treas. Reg. section 53.4941(e)-1(e)(1).

This exception requires a continuous self-dealing transaction to be valued each year during the taxable period. The amount involved is the greater of the amount paid for such use or the fair market value of such use for the period for which the money or other property is used. Treas. Reg. section 53.4941(e)-1(b)(2)(ii). The following example illustrates the computation of the total tax relating to a self-dealing transaction of an ongoing nature.

Assume that on July 1, 1988, a private foundation provided the use of an automobile to a disqualified person for four years. The disqualified person paid nothing for such use. The fair market value of such use on the day the act of self-dealing occurred was $12,000 for 1988, $12,000 for 1989, $13,000 for 1990, and $16,000 for 1991. The transaction was not corrected by the time the Service mailed a notice of deficiency with respect to the first-tier tax on September 30, 1991. Under Treas. Reg. section 53.4941(e)-1(e)(1), the transaction constitutes four separate acts of self-dealing, which are treated for purposes of I.R.C. section 4941 as occurring on July 30, 1988, January 1, 1989, January 1, 1990, and January 1, 1991. Thus, the taxable periods are:

1. July 1, 1988, to September 30, 1991;

2. January 1, 1989, to September 30, 1991;

3. January 1, 1990, to September 30, 1991;

4. January 1, 1991, to September 30, 1991.

Because an act of self-dealing occurred each year, the amount involved is $6,000 for the first taxable period, $12,000 for the second, $13,000 for the third, and $12,000 for the fourth. Thus, the tax under I.R.C. section 4941(a)(1) for each act of self-dealing is:

1. $6,000 X 5% = $300 a year. Because the taxable period includes four taxable years, the total tax for the first act of self-dealing is $1,200;

2. $12,000 X 5% = $600. Because the taxable period includes three taxable years, the total tax for the second act of self-dealing is $1,800;

3. $13,000 X 5% = $750. Because the taxable period includes two taxable years, the total tax for the third act of self-dealing is $1,500;

4. $12,000 X 5% = $600. Because the taxable period includes only a partial year, the total tax for the fourth act of self-dealing is $600.

See, e.g., Treas. Reg. section 53.4941(e)-1(e)(1)(ii) Example (2).

We also note that not all acts of self-dealing involve the full value of the transaction. For example, payment of compensation for reasonable and necessary personal services to a disqualified person, except to a government official, is not self-dealing so long as the amount is not excessive. Treas. Reg. section 53.4941(e)-1(b)(2). In such a case, the fair measure of the amount involved is not the amount exchanged, but rather any excess compensation the private foundation pays to the disqualified person. I.R.C. section 4941(e)(2).

I.R.C. section 4941(b)(1) imposes a second-tier tax of 200% of the amount involved in any case in which the first-tier tax of I.R.C. section 4941(a)(1) is imposed and the self-dealing act has not been corrected within the taxable period. The same persons who are liable for the first-tier self-dealing tax are also liable for the second-tier tax. I.R.C. section 4941(e)(2)(B) provides that the amount involved for purposes of the second-tier tax is the highest fair market value during the taxable period. If the act of self-dealing involves a continuing transaction for which new acts are deemed to occur, then the special rule of Treas. Reg. section 53.4941-1(e)(1)(i), which we discussed above, applies. If the special rule applies, then the amount involved must be separately determined for each act, including the deemed acts.

Finally, we note that ultimate liability for the second-tier tax is predicated on whether the taxpayer has corrected the self-dealing act within the correction period. I.R.C. section 4961(a) provides:

> If any taxable event is corrected during the correction period for such event, then any second tier tax imposed with respect to such event (including interest,

additions to the tax, and additional amounts) shall not be assessed, and if assessed the assessment shall be abated, and if collected shall be credited or refunded as an overpayment.

The correction period commences on the date the self-dealing act occurs. I.R.C. section 4963(e)(1). Its end depends on the process, if any, that the taxpayer pursues to question the application of the first- or second-tier taxes. See I.R.C. section 4963(e)(1). In the instant case, because the taxpayer timely petitioned the Tax Court to review the deficiency, the correction period ends when the Tax Court decision becomes final. Id. The decision becomes final when the appeal period runs or a court of appeals or the Supreme Court reaches a decision. I.R.C. sections 6214(d) and 7481(a). In addition, the Tax Court retains jurisdiction to conduct a supplemental hearing to determine whether the self-dealing act is corrected between the time it renders its decision and the date of finality of that decision. I.R.C. section 4961(b).

CONCLUSION

In light of the above analysis, we advise you to review the administrative file to determine for purposes of the applicable statute of limitations (1) when the [redacted] filed its returns for the taxable years covered by the statutory notices of deficiency and (2) whether those returns "adequately disclose" the acts of self-dealing. We leave it up to you to determine if it is appropriate and in the Government's best interest to amend the answer to assert additional taxes as outlined above. For subsequent years, consider the need to issue a statutory notice of deficiency prior to the expiration of the statute of limitations. Moreover, we recommend that you submit the administrative file to an experienced Tax Law Specialist in your key district to determine if the Service properly computed the private foundation excise taxes. Finally, please call Christopher B. Behling at FTS 566-3345 if we can be of further help to you.

MARLENE GROSS
Director

By: _____
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Enclosure: G.C.M. 39066